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# Towards a durable solution to the debt problems of developing countries

## Report of the Secretary-General

*Summary*

The present report, submitted pursuant to General Assembly resolution 63/206, contains a review of recent developments in the external debt of developing countries and economies in transition. It analyses the impact of the financial and economic crisis ignited by the collapse of the sub-prime mortgage market in the United States on external debt sustainability for countries having access to international capital markets and low-income countries and critically reviews related policy actions. The report describes progress of the Heavily Indebted Poor Countries Initiative and developments in Paris Club rescheduling and analyses new trends and modalities in multilateral financing. It discusses the implication of the increasing importance of private external borrowing for external debt sustainability.

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# I. Introduction

1. The present report is submitted to the General Assembly in accordance with paragraph 4 of Assembly resolution 63/206. It includes a comprehensive analysis of the external debt situation and debt-servicing problems of developing countries and transition economies. It seeks to describe new developments and key trends in external debt and related areas of development finance and to provide a basis for deliberation of related policy issues.

# II. Recent trends

2. During 2008, the dollar value of total external debt of developing and transition economies (henceforth developing countries owing to the lack of disaggregated data for transition economies) increased by $176 billion, surpassing $3.6 trillion at the end of the year. The output of developing countries grew more rapidly than debt and total external debt decreased from 25 per cent of gross national income (GNI) in 2007 to 21.8 per cent of GNI in 2008. As a group, developing countries continued to accumulate international reserves, which, by the end of 2008, surpassed $4.2 trillion (see annex).

3. The data in the annex are weighted averages and are heavily influenced by the behaviour of some large developing countries which, over the last few years, recorded rapid output growth and reserve accumulation. A simple average, which gives each country the same weight, would yield a debt-to-GNI ratio which is twice as large as the weighted average reported in the annex.

4. High average foreign exchange reserve is also driven by a few large countries. At the end of 2008, four countries (Brazil, China, India and the Russian Federation) held about two thirds of the total reserves of developing countries. As a consequence, there are large differences across regions and countries. While the East Asia and Pacific region and the Middle East and North Africa region hold reserves which are much larger than their external debts, all other developing regions have reserves lower than their external debts, but higher than their short-term external debt. There are, however, several countries in Eastern and Central Europe that have international reserves which are well below their short-term external debt.

5. Debt composition is also changing rapidly. In the first half of the current decade, about 60 per cent of total long-term external debt of developing countries was owed to private creditors (varying from 21 per cent in sub-Saharan Africa to 78 per cent in Latin America and the Caribbean); by 2008 the share of debt owed to private creditors was 75 per cent (ranging from 33 per cent in sub-Saharan Africa to 93 per cent in the transition economies of Eastern Europe and Central Asia). Over the same period, the share of total long-term external debt issued by private borrowers grew from 30 per cent to 50 per cent. Debt issued by private borrowers is particularly important in the transition economies of Eastern Europe and Central Asia, where it amounts to 72 per cent of total external long-term debt.

## III. Current economic crisis and risks to debt sustainability

6. The trends discussed above are a reflection of the benign conditions that characterized the world's economy over the period 2003-2007. They have not yet factored in the shock waves of the economic and financial crisis.

7. The early view that developing countries had managed to decouple their economies from those of the developed world is proving to be incorrect. Economic growth is slowing across all regions and several developing countries are expected to experience negative growth in 2009. Total growth of the developing world will remain positive in 2009, but if China and India are excluded from the group, output of the developing world will contract by approximately 1.5 per cent.

8. In 2008, GNI growth in Asia was 5.9 per cent (down from 8.1 per cent in 2007) and is expected to be just above 2 per cent in 2009; growth in the Latin American and Caribbean region is expected to decrease from 4.2 per cent in 2008 to negative 2.6 per cent in 2009; growth in Africa will decrease from 5.1 per cent to 1.2 per cent; and growth in Eastern Europe will swing from 5.4 per cent growth in 2008 to a loss of income of 5 per cent in 2009. About 62 developing countries out of 166 countries for which data are available are expected to record falling output in 2009 and a larger number of countries are expected to record decreasing income in per capita terms.

9. Developing countries as a group registered a current-account surplus of 3.5 per cent of GNI in 2007. This surplus dropped to 2.5 per cent in 2008 and is expected to shrink further to 1.6 per cent in 2009. In 2007, about 40 per cent of all developing countries had a current-account deficit greater than 6 per cent of GNI; by 2008 the share of developing countries with large current-account deficits had risen to 53 per cent. In 2006-2007, sub-Saharan Africa had a balanced current account and went into a deficit of 2.3 per cent of the region's GNI in 2008, which is expected to reach 5 per cent in 2009. About 84 per cent of countries in the region ran a current-account deficit in 2008, and 70 per cent of the countries in the region had a current-account deficit greater than 6 per cent of GNI. Latin America and the Caribbean and Eastern Europe and Central Asia registered a current-account deficit in 2008, which is likely to persist in 2009. East Asia and the Middle East and North Africa are likely to maintain current-account surpluses in 2009, but these surpluses are driven by a collapse of imports, rather than by dynamism in the export sector.

10. Financing these current-account deficits may become problematic for some developing countries. Preliminary data shows a 50 per cent reduction in net private capital flows to developing countries in 2008 and further reduction in 2009. This "reversal of international capital flows" as it is usually called, should not be regarded a priori as a curse for all affected countries. While many low-income countries do need external resources to finance productive imports, in many market-access countries private flows are often driven by speculative behaviour and end up in overvaluation of the currency and consumption booms. There are thus cases in which the reversal in private capital flows may have a minor effect on GDP growth and even help the affected countries to move towards a more sustainable growth model.[1]

[1] See United Nations Conference on Trade and Development, *Trade and Development Report 2008* (United Nations Sales publication, E.08.II.D.21), chap. IV.

11. The crisis is also taking its toll on the availability and cost of trade finance. Spreads on 90-day letters of credit have increased by a factor of 25, going from 10-20 basis points to 250-500 basis points. As a reaction to this situation, the communiqué of the Summit of the Group of 20, held in London in April 2009, included a $250 billion package in support of trade finance.

## A. Countries with access to international capital markets

12. Countries that tap the international capital markets are facing higher borrowing costs driven by the global increase in risk aversion. This increase in borrowing cost may endanger the solvency of private borrowers based in emerging markets as a large share of their external debt contracted during the period 2003-2007 is now coming due.[2]

13. Sovereign spreads measure the difference between the interest rate paid by dollar-denominated sovereign bonds issued by emerging market countries and bonds with similar characteristics issued by the Government of the United States of America. Average sovereign spreads went from approximately 200 basis points in the summer of 2007 to almost 900 basis points in October 2008. During the first half of 2009, when the "flight to quality" faded, spreads decreased again, but they remain significantly higher than before the financial crisis. The evolution of sovereign spreads shows that developing countries that borrow from the international capital market pay a price for external shocks that are unrelated to domestic policies.

14. In most cases, high borrowing costs are not justified by deteriorating fundamentals but are the result of the general "risk aversion" that was triggered by a shock originating elsewhere. The same markets that had shown their "confidence" in the policies of developing and transition economies by appreciating the currencies of these economies suddenly turn around and flee these markets as if economic policy would have changed dramatically.

15. As most developing countries borrow abroad in foreign currency, the behaviour of the exchange rate plays a key role in determining borrowing costs of these countries. Since mid-2008, the negative effect of higher spreads has been magnified by the fact that the currencies of several emerging markets and low-income countries have depreciated vis-à-vis the United States dollar.

16. Lower economic growth and higher financing costs are likely to cause a deterioration of the external debt situation of developing and transition economies. Thanks to prudent policies implemented during the past five years, many middle-income countries are endowed with large war chests of reserves. They are thus well equipped to face one or two years of tight capital markets. The situation is different for several low-income countries which are close to running out of reserves. Countries with liquidity problems have been able to access stepped-up International Monetary Fund (IMF) resources. However, if the current conditions persist beyond 2009, several countries are likely to start facing serious liquidity and solvency problems.

[2] The World Bank estimates that developing countries corporate debt falling due in the first six months of 2009 amounted to $100 billion.

17. Until now, the Eastern and Central Europe region has been most severely affected by the crisis. In 2009, it is estimated that the region will experience the deepest output contraction since 1994 and a worsening of debt-to-GNI ratios in most countries. There are, however, important differences among countries in the region. The most affected countries are those that ran large current-account deficits in the period 2003-2007, often in excess of 10 per cent of GNI. These countries also experienced speculation in their currencies and credit booms driven by excessive lending to households with loans that were often denominated in foreign currency. The burst of the property bubble fuelled by the credit boom restricted the lending capacity of the banking sector. The ensuing credit crunch further exacerbated the drop in manufacturing output and exports. Because of the presence of large foreign-currency liabilities, several countries refused to accommodate these pressures and devalue their currency. Since mid-2008, seven countries in the region accessed IMF facilities and more countries received support from the European Union. However, the measures taken so far by the international financial community might not be sufficient to restore market confidence, as demonstrated by Latvia's failure to issue about $100 million of treasury bills in June 2009.

## B. Low-income countries

18. Many low-income countries are on the brink of a balance-of-payment crisis brought about by terms-of-trade shocks, decline in export demand, and reduction in tourism and remittance flows. According to the World Bank, 18 countries have international reserves which cover less than four months of imports and 16 countries have consumed 20 per cent or more of their reserves since September 2008.[3] Several HIPCs are affected by the global economic and financial crisis through a number of channels. Completion-point countries are facing an average current-account deficit of 8 per cent of GNI and the average current-account deficit of decision-point and pre-decision-point countries exceeds 10 per cent of GNI. This highlights the need for highly concessional or grant based external financing for all HIPCs, including post-completion-point countries.

19. The traditional channel through which the global economic cycle affects growth in low-income countries is the collapse in demand for commodities, on which low-income countries depend highly. Another channel is through the lending activities of foreign-owned banks which controlled nearly 40 per cent of the domestic banking assets of developing countries at the end of 2007.[4]

20. An analysis of the impact of the global economic crisis on debt sustainability in a sample of 49 low-income countries found that the financial leverage of the banking system increased markedly since mid-2008. This increase in leverage makes these countries vulnerable to systemic banking crises which may have negative effects on economic activity and debt sustainability. There is evidence that

[3] World Bank, Global Development Finance 2009 (Washington, D.C., 2009).

[4] The presence of foreign banks is particularly important in Eastern Europe and Central Asia and in sub-Saharan Africa. Contrary to conventional thought, foreign banks located in low-income countries are often less efficient than domestic banks. See Detragiache, Tressel, and Gupta, 2008, "Foreign Banks in Poor Countries: Theory and Evidence", *Journal of Finance*, vol. 63.

foreign-owned banks have contributed to this overall increase in leverage and thus to the propagation of the crisis.[5]

21. Given the devastating effects of the financial crisis and the urgent need to prevent the worsening of debt ratios, which may lead to lower social expenditures and increase poverty, the UNCTAD secretariat proposed a temporary debt moratorium or standstill on official debt for low-income countries.[6] In comparison to the size of the stimulus packages for developed countries, the total amount of such a temporary debt moratorium is miniscule, constituting about $26 billion for 49 low-income countries for 2009 and 2010 combined. However, such a policy could provide recipient countries with breathing space and offset some of the negative effects of contracting export revenue and financial inflows. The moratorium could function as a counter-cyclical measure and, by contributing to macroeconomic stability in recipient economies, play a role in sustaining global demand.

## IV. Private external debt and its vulnerabilities

22. The development and deepening of financial markets and financial reform policies have enhanced access to the international capital markets by private borrowers from developing countries. In the early 1990s, less than 10 per cent of total external long-term debt issued by developing countries was owed by private borrowers and most foreign borrowing was done by the public sector. Over the last 15 years, private firms and banks have been drawing finance from international markets in increasingly larger amounts. As a consequence, the share of total external long-term debt owed by private borrowers increased to 22 per cent in the second half of the 1990s, it surpassed 30 per cent in the first half of the current decade, and reached 50 per cent in 2008.

23. Data from the Bank for International Settlements on total bank cross-border claims by reporting banks and total international securities are less comprehensive than those reported in the annex to the present report, but allow for a finer breakdown of the borrower type for both short-term and long-term external debt. These data indicate that about 80 per cent of total external debt of developing countries was owed by private sector borrowers at the end of 2008.

24. According to the World Bank, more than 3,000 corporations based in emerging markets tapped the international capital markets during 2002-2007 either by issuing bonds or borrowing through syndicated bank loans. As a result, corporate debt is now responsible for the majority of short-term external debt of developing countries.[3]

25. There are, however, large regional differences. Debt owed by private borrowers is particularly important in countries with access to international capital markets and upper middle-income countries. Thus, the share of this debt to total long-term external debt in 2008 is large, in Latin America and the Caribbean (42 per cent), in East Asia (45 per cent), and in Eastern Europe and Central Asia (72 per cent), whereas it is much smaller in sub-Saharan Africa (12.7 per cent) and South

[5] Gande and Senbet (2009) "The Impact of Global Economic Crisis on Debt Sustainability of Low-Income Countries", unpublished, University of Maryland.

[6] See A/CONF.214/3, draft outcome document of the Conference on the World Financial and Economic Crisis and Its Impact on Development, para. 15.

Asia (26 per cent). Surprisingly, the share of debt owed by private borrowers is the lowest in the Middle East and North Africa region (7.5 per cent), which includes several middle- and high-income countries. This may be due to the fact that in some cases it is difficult to distinguish between public and private debt. This is especially the case in the smaller Gulf countries which have undertaken several public-private projects. With regard to the United Arab Emirates, while official statistics report no private external debt, it issued $100 billion of publicly guaranteed corporate debt between 2006 and 2008, making it one of the largest issuers of external corporate debt in the emerging world.

26. Private sector entities are now able to access the international capital market, which diminishes the traditional role of the State as an intermediary for such financing. It has been argued that since private agents (both lenders and borrowers) are better equipped at evaluating the risk of their actions, private external borrowing does not lead to vulnerabilities as long as the fiscal accounts are balanced. This view was discredited by several debt crises, which hit countries with high private investment rates and balanced fiscal accounts. Therefore, the fact that a country has a large share of its external debt owed by private borrowers should not be interpreted as an indication of lower vulnerabilities. In fact, it is often impossible to separate public from private liabilities and this is especially the case for bank debt, which, due to implicit or explicit deposit insurance, is a contingent liability of the public sector.

27. There are conditions under which private external debt may lead to overborrowing and generate more vulnerabilities than public sector external debt. Large inflows of private capital can lead to overvaluation, with the concomitant loss of competitiveness and unsustainable current-account deficit. Moreover, private external debt often leads to the accumulation of currency mismatches in the balance sheets of firms and households. Overconfidence in the private sector's ability to cope with a general loss of competitiveness has been at the root of many financial crises, including the one in East Asia in 1997/98 and the most recent one in Eastern Europe and Central Asia. In the end, the unavoidable depreciation hurts the banks if their clients have currency mismatches in their balance sheets. This occurs when firms that produce non-tradable goods borrow in a foreign currency or when households hold mortgages denominated in a foreign currency because the interest rate there is lower.

28. It is difficult to implement prudential regulation aimed at avoiding such mismatches because the total external exposure of the private sector is more difficult to measure and quantify than the external exposure of the public sector. Such difficulties are amplified by the fact that private agents often assume currency risk by using sophisticated derivative instruments. Policies aimed at developing domestic bond markets may enable corporations to avoid excessive external exposure, but developing countries need to be careful to avoid policies that could increase the risk of financial instability by facilitating inflows and outflows of hot money.

29. Private external borrowing also plays a central role in the diverging trends of the net and gross external liabilities of developing countries. In 1970, net international liabilities (both debt and equity) of developing countries as a group made up about 18 per cent of the group's total GNI. These net liabilities resulted from the difference between gross international liabilities amounting to 27 per cent

of the group's GNI and gross international assets amounting to 9 per cent of the group's GNI. By 2004, net international liabilities had decreased to 2 per cent of GNI, but gross exposure had increased to 80 per cent of the group's GNI. Larger gross assets and liabilities may bring advantages in terms of international diversification and access to technology but they also increase vulnerabilities linked to valuation effects or sudden capital flow reversals.

# V. Debt relief and official development assistance

## A. Progress under the Heavily Indebted Poor Countries Initiative

30. As of June 2009, 35 of the 40 eligible countries qualified for debt relief under the enhanced HIPC Initiative. In January 2009, Burundi was the twenty-fourth country to reach completion point under the Initiative. Since the last report, Togo (November 2008) and Côte d'Ivoire (March 2009) reached decision-point, increasing the number of decision point countries to 11. Countries that are making progress towards reaching completion point include Afghanistan, the Central African Republic, Guinea, Guinea-Bissau, Haiti and Liberia. With the exception of the Kyrgyz Republic, which may decide to officially opt out from the Initiative, the remaining pre-decision-point countries are conflict or post-conflict cases, in which progress can be expected to be very limited.

31. Completion-point countries received an estimated debt relief of $38 billion in end-2008 NPV terms. World Bank estimates suggest that the debt stocks of the 35 post-decision point HIPCs have declined by approximately 80 per cent and debt ratios have substantially improved from 1999 to 2008 with respect to net present value (NPV) of debt to exports (from 457 per cent to 133 per cent), NPV of debt to GNI (from 114 per cent to 38 per cent), debt service to exports (from 18 per cent to 6 per cent), NPV of debt to revenue (from 552 per cent to 153 per cent) and debt service to revenue (from 22 per cent to 6 per cent). These improvements do not automatically imply a more favourable medium-term debt situation for these countries. Of the 24 HIPC completion-point countries, only 8 are classified as being at low risk of debt distress, while 4 countries are classified as being at high risk or are already in debt distress.

32. All completion-point HIPCs have benefited from additional debt relief under the Multilateral Debt Relief Initiative (MDRI), but not all HIPCs benefit equally from the MDRI as the Asian Development Bank does not participate in the Initiative.

## B. Paris Club activities

33. Since the last report (A/63/181), six countries rescheduled their debt with Paris Club creditors.[7]

34. In October 2008, Djibouti concluded an agreement with Paris Club creditors to reschedule its debt under Houston terms, including a full deferral of moratorium

[7] Countries covered in the previous report that rescheduled their Paris Club debt in 2008 are the Gambia, Guinea, Liberia and Togo.

interest during the 36-month consolidation period. The agreement covers principal, interest and arrears at the end of August 2008, as well as a deferral on payments of post-cut-off debt and short-term debt during the consolidation period. Creditors have expressed their willingness to consider a debt treatment under the Evian approach at some future date.

35. The Republic of the Congo reached the decision point under the HIPC Initiative in March 2009, and a Paris Club meeting ensued in December 2009. Debt payments falling due over the three-year consolidation period were treated under Cologne terms, leading to a cancellation of approximately $805 million and a rescheduling of $155 million.

36. Togo reached the decision point in November 2008 and had a Paris Club meeting in January 2009. It obtained a rescheduling under Cologne terms of its debt obligations falling due during the consolidation period. This treatment led to an additional cancellation of $22 million of debt owed to Paris Club creditors. A number of creditors have expressed their willingness to grant additional debt relief beyond the agreed terms.

37. Burundi reached the completion point in January 2009 and had a Paris Club meeting in March 2009. The treated loans comprised the debt stock as of 1 January 2009 and arrears as of 31 December 2008. Burundi obtained a 100 per cent cancellation of official development assistance (ODA) and non-ODA loans as well as a 95 per cent reduction of the previously rescheduled ODA credits, which represents an annulment of $129.5 million of external debt obligations. With further bilateral pledges, the country will no longer have Paris Club debts following that agreement.

38. The financial crisis contributed to a collapse in tourism revenues of the Seychelles, on which the country heavily depends. As a consequence, the Seychelles became unable to continue servicing its debts. A Paris Club meeting took place in April 2009. It led to a treatment under the Evian terms and gave rise to a complex agreement. All arrears as of the end of October 2008 and maturities due between November 2008 and June 2009 were first rescheduled and deferred. Then an NPV reduction of 31.4 per cent was applied on all outstanding principal due as of July 2009 after the rescheduling and deferral have been applied. A further reduction was agreed on the remaining outstanding principal due on 1 July 2010 after the implementation of the first reduction, with the aim of achieving an overall 50 per cent NPV cancellation of the treated debt stock.

39. Côte d'Ivoire reached decision point under the HIPC Initiative in March 2009 and had a Paris Club creditors meeting in May 2009. Debt obligations falling due during the consolidation period were treated under the Cologne terms, but as the country's external viability required further assistance, creditors agreed to go beyond the usual terms and granted a capitalization of moratorium interest with a six-year deferral, as well as a deferral of arrears over 7.5 years. Creditors also agreed to a deferral on repayments of arrears on post-cut-off date debts and to a deferral on obligations falling due during the consolidation period on post-cut-off-date debts. This treatment is a sign that official bilateral creditors are willing to provide exceptional assistance to countries needing it to regain sustainability.

### C. Trends in official development assistance

40. Official development assistance (ODA) by Development Assistance Committee (DAC) donors rose to its highest level in 2008, $119.8 billion, reaching 0.3 per cent DAC donors' total GNI. About 7 per cent of the total consisted of debt relief and ODA net of debt relief increased by 12 per cent with respect to 2007. It is possible that this increase in ODA still reflects decisions taken during the previous period of high and stable economic growth in donor countries and that the ODA may be negatively affected by the current crisis.

41. Organization for Economic Cooperation and Development (OECD) estimates suggest that donors will need to increase current ODA expenditures by $10-15 billion to meet their aid commitments for 2010; but aid targets may fall short of the additional development resources needed to respond to the challenges posed by the global crisis. Aid will have an important role to play in providing much needed counter-cyclical resources and help Governments to support social expenditure and expand infrastructure.

42. During past banking crises in donor countries, ODA has dropped anywhere from 20 to 40 per cent and then recovered very slowly. Besides budget cuts, economic crises in the donor countries may lead to an automatic reduction in ODA because some donors set their aid targets as a percentage of GNI, and so a drop in GNI may lead to a drop in aid. Moreover, aid budgets are usually fixed in domestic currency; should that currency depreciate against the recipient's currency, the value of the aid budget will decrease as well. There is thus a risk that aid will decrease at a time when it is needed the most. A collapse in aid could eliminate some of the progress towards meeting the Millennium Development Goals.

43. A positive sign is that several donor countries restated their commitment to foreign aid. By adopting the Action Plan of the DAC High-Level Meeting held on 27 and 28 May 2009, donors acknowledged the need for meeting the current aid shortfall and signalled their willingness to deploy additional resources to multilateral institutions. However, aid could be made more stable and predictable by developing funding modalities in which the budgets of the various aid agencies no longer depend on the business cycle of donor countries.[8]

## VI. New trends and modalities in multilateral financing

44. The period 2003-2007 was characterized by strong global economic growth. A large number of developing countries also registered large current-account surpluses and faced low external finance requirements. Moreover, abundant international liquidity and low risk aversion allowed several developing countries to borrow from the international capital market at spreads comparable to the interest rates charged by the international financial institutions, without any burden in terms of conditionality. As a consequence, lending by the largest international financial institutions decreased dramatically over this period. For instance, the International Bank for Reconstruction and Development (IBRD) — the non-concessional lending

[8] United Nations Conference on Trade and Development, "Keeping ODA afloat: no stone unturned", UNCTAD Policy Brief No.7, March, 2009 (http://www.unctad.org/en/docs/presspb20092_en.pdf).

arm of the World Bank Group — had consecutive negative net flows throughout the period 2002-2007, meaning that debt repayments were greater than new issuances of loans. In the case of IMF, outstanding credit went from $96 billion in 2002 to $15 billion in 2007.

45. Access to multilateral finance is now much more attractive and needed because several developing countries started having current-account deficits exactly when international liquidity began drying up and sovereign spreads started soaring. Net lending by the World Bank went from negative $500 million in 2007 to positive $2.8 billion in 2008 and it is expected to increase at a very fast pace over the next three years. For instance, IBRD gross lending, which stood at $13 billion in 2008, up from $10 billion in 2007, is expected to reach $35 billion in 2009, with total gross lending exceeding $100 billion over the period 2009-2011. Most of the new loans are expected to take the form of fast-disbursing Development Policy Loans. The World Bank is also increasing lending by its concessional arm — the International Development Association — and is making $2 billion available for fast track financial assistance in the form of grants and interest-free loans for social safety nets, infrastructure, education and health. Finally, the private-sector arm of the World Bank — the International Finance Corporation — is also expected to increase its activities in support of public-private infrastructure projects, bank lending in emerging and low-income countries, microfinance institutions, and trade finance.

46. The regional development banks are also stepping up lending. In Latin America and the Caribbean, the Inter-American Development Bank aims at providing a credit line of $6 billion to member countries that face liquidity problems. Latin American countries with liquidity problems will also be able to access a $1.5 billion facility created by the Andean Development Corporation and the seven members of the Latin American Reserve Fund will have access to a $1.8 billion balance-of-payment support credit line.

47. In Africa, the African Development Bank created a $1.5 billion facility for countries that have liquidity problems and need rapid access to credit. It also coordinated several agencies towards the creation of the African Financing Partnership with the objective of providing $15 billion worth of loans for infrastructure, agribusiness and small and medium-size enterprises to promote trade, and to strengthen financial sectors.[9]

48. In Asia, the Board of the Asian Development Bank announced a tripling of the Bank's capital base from $55 billion to $165 billion. The ADB intends to increase lending by more than $10 billion to $32 billion for 2009-2010. It also created a $3 billion facility for countries that face liquidity problems and need balance-of-payment support. The ASEAN+3 group agreed on a programme labelled Chiang Mai Initiative Multilateralization, which establishes a $120 billion regional fund aimed at providing short-term liquidity support to countries that face foreign exchange risk. Japan also announced its intention to supply Asian nations with an additional $60 billion in emergency swap agreements and to provide guarantees on yen-denominated bonds issued in Japan by foreign countries or companies.

[9] The partnership includes the Agence Française de Développement, the Development Bank of Southern Africa, the European Investment Bank, the German Federal Ministry for Economic Development and Cooperation, the Islamic Development Bank and the World Bank.

49. A strong indicator of the deepening of the global economic crisis is the sharp increase in the demand for IMF loans and assistance. Over the period from the first quarter of 2002 to the third quarter of 2008, there were an average of six countries seeking non-Poverty Reduction and Growth Facility (PRGF) loans annually. Between November 2008 and May 2009, 23 countries began accessing non-PRGF IMF facilities. Of these 23 facilities, 13 were traditional stand-by agreements, 7 of which have been approved under the IMF fast-track Emergency Financing Mechanism procedure.[10] An additional seven loan agreements were extended under the Exogenous Shock Facility and three agreements under the newly created Flexible Credit Line facility.[11]

50. The Flexible Credit Line is a facility that seeks to provide rapid access to credit to countries that pre-qualify under the terms of the facility. Its stated aim is to eliminate uncertainties about a country's ability to access IMF resources. Only countries that are deemed to have strong economic fundamentals and policies and are committed to continue such policies in the future are eligible to access the facility.[12]

51. Besides introducing ex ante qualification criteria, as in the case of the Flexible Credit Line, the IMF also announced the "modernization" of conditionality attached to loans, effective 1 May 2009. The intention is to move to a review-based approach to monitoring the implementation of IMF programmes instead of using performance criteria. The intention of the new approach is to adapt conditions attached to loans to country-specific circumstances and eliminate the need for formal waivers for countries that do not meet targets by a specific date.

52. While the introduction of some flexibility may be a step in the right direction, there is the risk that these reforms and new facilities will not substantially alter traditional IMF conditionality which has been the subject of many criticisms in the past. A 2007 IMF Independent Evaluation Office report entitled "Structural Conditionality in IMF Supported Programs" found that a number of the IMF conditionalities reach outside the Fund's core areas of responsibility. It remains to be seen whether the reform will indeed limit IMF conditionality to the Fund's mandated areas of work or if it will only lead to operational rather than substantive changes to conditionality.

53. The G-20 and International Monetary and Financial Committee communiqués of April 2009 requested a revision of the IMF/World Bank Debt Sustainability Framework for low-income countries with the objective of enhancing the flexibility of the Framework. The current version of the Debt Sustainability Framework uses explicit limits on the NPV of external debt, above which external debt is considered unsustainable. There are serious issues on how these thresholds are calculated and how they relate to the World Bank's Country Policies and Institutional Assessment

[10] This financing mechanism was established in 1995 to provide rapid financing to member countries. Until September 2008 the mechanism had been employed only five times: four times during the Asian crisis and once for Turkey in 2001.

[11] A precursor of the Flexible Credit Line was the Contingent Credit Line, which was created in 1999 but discontinued in 2003 because no country ever applied for the facility.

[12] Qualification criteria include: strength of the current account, strength of public finances, the sustainability of public debt, and level and stability of inflation.

index (see A/63/181).[13] The World Bank and IMF are elaborating a proposal aimed at addressing some of the issues raised by critics of the Debt Sustainability Framework, but it appears that the Country Policies and Institutional Assessment index will remain central to calculating debt thresholds.

54. The Debt Sustainability Framework does not make any distinction between debt used to finance investment projects and debt used to finance current expenditure (ibid.). This is problematic because investment projects can increase GNI growth and thus improve a country's ability to service its debt. A more flexible Debt Sustainability Framework which allows for higher debt thresholds when external borrowing is used to finance high-return investment projects would be desirable as it would recognize that not every increase in debt leads to a reduction in government wealth. Moreover, as current expenditure tends to be the most rigid component of the government budget and investment is the typical adjustment variable when the debt exceeds the threshold fixed by the Debt Sustainability Framework, adding flexibility to that Framework may contribute to reducing the volatility of public investment in developing countries.[14]

55. In increasing the flexibility of the Debt Sustainability Framework, it is necessary to recognize that financing investment projects that generate returns which are higher than the interest rate charged on the loan is a necessary but not sufficient condition for external sustainability. Only projects that have a high return and can, either directly or indirectly, generate the foreign currency necessary to service the debt will not harm external sustainability.[15]

56. An additional issue relates to debt composition that recent research has shown to be as important as debt levels in determining debt sustainability.[16] The Debt Sustainability Framework should be revised and expanded to include both domestic and foreign debt and control for debt structure by giving different weights to different types of debt. For instance, all other things being equal, long-term debt denominated in domestic currency generates less vulnerabilities than short-term debt denominated in foreign currency. The recent discussion in the IMF Executive Board on building debt thresholds that consider the currency-denomination of domestic debt is a welcome step in the right direction.[17]

57. A related issue has to do with the fact that several low-income countries that are eligible to borrow under the IMF Poverty Reduction and Growth Facility or have access to IDA loans face minimum concessionality requirements that prevent them from engaging in external borrowing that does not have a concessional component of at least 35 per cent. Current proposals aimed at granting more flexibility to these countries focus on "average" concessionality requirements, under which new

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[13] The appropriateness of the Country Policies and Institutional Assessment index was recently questioned by the IMF Executive Board, which agreed on the need for "objective, credible criteria" for the assessment of macroeconomic management capacities (see IMF, Public Information Notice No. 09/39, March 30, 2009).

[14] Governors representing 11 borrowing members of the Inter-American Development Bank discussed this problem in a 2004 open letter known as the "Carta de Lima".

[15] See United Nations Conference on Trade and Development, *Trade and Development Report 2008*.

[16] Inter-American Development Bank (2007), *Living with Debt: How to Limit Risks of Sovereign Finance*.

[17] International Monetary Fund, Public Information Notice No. 09/38, "IMF Executive Board Discusses Reforms of Lending Instruments for Low-Income Countries", March 30, 2009.

external borrowing by these countries needs to have an average rate of concessionality of at least 35 per cent but individual loans may have lower levels of concessionality. More should be done in reducing total concessionality requirements, especially because there is some discussion of making concessionality requirements even tighter for countries which, according to the Debt Sustainability Framework, are deemed to face a high risk of debt distress.

## VII. Policy conclusions

58. Developing countries are paying a steep price for an economic crisis caused by policy and regulatory mistakes of some developed countries. Prevention of future crises will require more even-handed surveillance of all major financial centres (see A/CONF.214/3). Decisive and bold policy action is required to limit the setbacks in terms of increased poverty and progress towards the Millennium Development Goals resulting from the crisis. It is reassuring that the G-20 communiqué of April 2009 acknowledged that the global financial system is ill-equipped for responding to the current crisis and agreed to deliver a large policy package. Another positive step is the recognition that developing countries that are hit by external shocks need to be provided with ample liquidity with no strings attached. This is a positive deviation from the old attitude that "if a country is in crisis, it must be its fault."

59. There are, however, also sources of concern. First and foremost, the G-20 communiqué did not recognize that the current crisis stems from excessive speculation made possible by the absence of a coherent global monetary and regulatory system and it did not agree on a coordinated global stimulus package.[18] Second, some of the resources necessary to fund the proposed $1.1 trillion package agreed upon in the G-20 communiqué have yet to be identified. Moreover, it is not yet clear what terms and conditions will be attached to the new resources and whether IMF, which will receive more than 70 per cent of the new resources, will truly reform its conditionality policies. Third, the G-20 did not allocate enough resources to low-income countries and small and vulnerable States.[19]

60. Low-income countries have limited ability to respond to external shocks and many of them are facing difficulties in servicing their external debt. It is the duty and obligation of the international community to provide assistance and resources to help mitigate the adverse consequences of the crisis without requiring the accumulation of unsustainable levels of debt.[20]

61. Low-income countries with high debt levels need to be given alternative financing opportunities for Millennium Development Goals achievement. A debt moratorium or standstill would immediately and unconditionally liberate resources

[18] UNCTAD (2009), *The global economic crisis: systemic failures and multilateral remedies*, report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation.

[19] Only $50 billion were targeted specifically to low-income countries (A/CONF.214/3). Nearly one quarter of the additional resources committed by the G-20 will take the form of the issuance of special drawing rights. Since special drawing rights are allocated according to IMF quotas, only about one half of the increase in special drawing rights will be translated into the Fund's ability to extend loans to developing countries, with a very small share going to low-income countries.

[20] There are some low-income countries that are able to absorb larger amounts of debt, which should be granted more flexibility under the Debt Sustainability Framework.

and give countries the fiscal space to respond to the specific circumstances they are facing. Such a moratorium can be viewed as a part of a multifaceted approach to mitigating the impact of the crisis and reduce the build-up of unsustainable debt in vulnerable economies.

62. Past experience shows that financial crises in donor countries are followed by a collapse in foreign aid. While several donors have committed to increase aid, it is worrisome that the G-20 communiqué did not include any clear commitment to increasing aid to low-income countries. Switching to a system in which aid agencies are funded with an endowment would be useful in delinking aid delivery from the business cycle of donor countries and thus reduce aid procyclicality. In fact, it would also be advisable to develop aid delivery mechanisms with a built-in insurance component which leads to an automatic increase in aid when recipient countries are hit by a negative external shock. Along similar lines, the international community should help countries with market access to develop new debt instruments and institutions which automatically reduce (or at least avoid amplifying) debt service in the presence of negative external shocks (A/CONF.214/3, para. 31, highlights the need to devise mechanisms aimed at providing more stable sources of development finance).

63. A continued deterioration of economic conditions may push some countries with access to international capital markets towards sovereign default. It is thus lamentable that the design of a mechanism aimed at facilitating the resolution of sovereign insolvency has been marginalized in the international discussion. The outcome document of the Conference on the World Financial and Economic Crisis underlines the need of a more structured framework for international cooperation in this area (A/CONF.214/3, para. 34). In this context, it would also be desirable for the international community to discuss and promote responsible lending and borrowing.

## Annex

### External debt of developing countries[a]

(Billions of United States dollars)

| | *All developing countries and economies in transition* | | | | | | *Sub-Saharan Africa* | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] |
| Total debt stocks | 1 468.8 | 2 061.5 | 2 397.6 | 2 858.4 | 3 466.0 | 3 642.0 | 191.4 | 226.2 | 217.9 | 172.5 | 195.1 | 199.7 |
| Long-term debt | 1 192.3 | 1 660.0 | 1 931.8 | 2 195.5 | 2 602.3 | 2 785.7 | 158.2 | 177.1 | 180.6 | 127.1 | 143.9 | 146.2 |
| Private (share) | 47.6 | 54.3 | 60.5 | 70.8 | 74.3 | 75.4 | 25.2 | 24.0 | 21.5 | 30.0 | 33.0 | 33.3 |
| Private non-guaranteed (share) | 8.4 | 21.8 | 29.6 | 43.8 | 49.6 | 49.5 | 4.1 | 5.6 | 5.3 | 6.8 | 10.9 | 12.7 |
| Short-term debt | 240.0 | 336.2 | 385.6 | 643.1 | 848.2 | 830.5 | 26.3 | 41.3 | 30.5 | 42.3 | 47.9 | 49.5 |
| Arrears | 119.8 | 117.4 | 94.8 | 90.9 | 95.7 | 97.8 | 40.1 | 59.7 | 39.5 | 39.6 | 39.9 | 39.5 |
| Debt service | 130.5 | 240.6 | 347.4 | 481.3 | 501.3 | 512.9 | 8.6 | 12.4 | 12.6 | 20.6 | 15.6 | 15.4 |
| International reserves | 268.7 | 564.2 | 1 198.3 | 2 653.0 | 3 751.5 | 4 219.8 | 16.0 | 26.7 | 49.4 | 114.9 | 140.4 | 155.4 |
| **Debt indicators (percentage)** | | | | | | | | | | | | |
| Debt service/exports | 18.5 | 19.3 | 17.2 | 12.3 | 10.2 | 8.0 | 12.7 | 14.7 | 9.4 | 7.6 | 5.0 | 3.7 |
| Total debt/exports | 180.8 | 149.2 | 107.1 | 65.6 | 65.8 | 57.0 | 243.2 | 227.0 | 150.6 | 60.3 | 56.8 | 48.0 |
| Debt service/GNP | 3.3 | 4.5 | 5.0 | 4.2 | 3.6 | 3.1 | 3.0 | 3.9 | 3.1 | 3.0 | 2.0 | 1.7 |
| Total debt/GNP | 37.3 | 38.2 | 34.8 | 25.1 | 25.1 | 21.8 | 67.6 | 70.8 | 54.9 | 24.7 | 24.9 | 22.2 |
| Reserves/short-term debt | 112.0 | 167.8 | 310.7 | 412.5 | 442.3 | 508.1 | 60.7 | 64.5 | 161.9 | 271.7 | 293.3 | 313.9 |
| Reserves/M2 | 14.3 | 19.5 | 23.1 | 30.1 | 33.8 | 31.1 | 14.9 | 21.8 | 27.7 | 34.0 | 27.9 | 32.7 |

| | *Middle East and North Africa* | | | | | | *Latin America and Caribbean* | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] |
| Total debt stocks | 124.7 | 131.6 | 129.4 | 129.3 | 136.4 | 133.5 | 483.9 | 684.2 | 772.3 | 729.0 | 825.7 | 865.0 |
| Long-term debt | 103.7 | 114.9 | 111.3 | 107.3 | 113.4 | 112.7 | 375.4 | 541.4 | 645.6 | 622.9 | 684.8 | 723.9 |
| Private (share) | 37.3 | 26.5 | 34.1 | 42.8 | 41.5 | 42.0 | 64.5 | 74.1 | 78.2 | 80.3 | 82.4 | 82.3 |
| Private non-guaranteed (share) | 0.9 | 2.1 | 1.1 | 6.0 | 5.7 | 7.5 | 11.7 | 30.7 | 34.8 | 36.9 | 41.1 | 42.4 |
| Short-term debt | 19.2 | 13.9 | 16.3 | 21.5 | 22.7 | 20.5 | 93.0 | 120.5 | 97.4 | 105.4 | 140.1 | 140.3 |
| Arrears | 4.9 | 2.3 | 0.8 | 0.3 | 0.3 | 0.3 | 43.5 | 12.1 | 20.1 | 21.5 | 25.2 | 27.5 |
| Debt service | 15.9 | 17.1 | 16.6 | 28.5 | 18.2 | 20.3 | 43.4 | 107.9 | 137.4 | 176.9 | 147.5 | 137.7 |
| International reserves | 25.4 | 43.8 | 85.3 | 169.1 | 216.3 | 261.8 | 92.0 | 160.0 | 192.9 | 312.8 | 450.6 | 500.5 |
| **Debt indicators (percentage)** | | | | | | | | | | | | |
| Debt service/exports | 21.0 | 18.5 | 11.5 | 11.0 | 5.8 | 5.1 | 25.0 | 33.6 | 30.6 | 22.9 | 16.0 | 12.3 |
| Total debt/exports | 147.5 | 132.9 | 85.3 | 48.1 | 41.3 | 33.2 | 235.1 | 194.4 | 152.2 | 85.6 | 85.4 | 77.2 |
| Debt service/GNP | 7.7 | 5.6 | 4.1 | 4.8 | 2.5 | 2.3 | 3.4 | 5.8 | 7.0 | 6.0 | 4.2 | 3.4 |
| Total debt/GNP | 60.5 | 43.4 | 32.5 | 22.0 | 19.0 | 15.3 | 38.8 | 36.9 | 39.6 | 24.5 | 23.7 | 21.5 |
| Reserves/short-term debt | 132.6 | 315.5 | 524.0 | 786.0 | 953.1 | 1 278.1 | 98.9 | 132.8 | 198.0 | 296.8 | 321.7 | 356.8 |
| Reserves/M2 | 14.1 | 20.7 | 25.8 | 32.4 | 34.0 | 35.1 | 15.4 | 23.3 | 21.3 | 20.7 | 24.4 | 23.5 |

| | *East Asia and Pacific* | | | | | | *South Asia* | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] |
| Total debt stocks | 300.5 | 509.7 | 546.4 | 666.5 | 741.5 | 765.5 | 138.1 | 154.2 | 176.1 | 249.8 | 304.7 | 311.3 |
| Long-term debt | 239.7 | 396.3 | 398.1 | 418.5 | 450.7 | 475.9 | 122.0 | 142.5 | 165.8 | 217.7 | 253.3 | 264.0 |
| Private (share) | 47.5 | 59.3 | 56.3 | 58.6 | 60.7 | 62.5 | 24.7 | 27.9 | 35.7 | 45.5 | 48.6 | 48.3 |
| Private non-guaranteed (share) | 15.6 | 32.3 | 33.2 | 38.4 | 43.0 | 44.7 | 2.7 | 7.2 | 15.0 | 39.7 | 41.2 | 26.1 |
| Short-term debt | 59.2 | 105.4 | 136.1 | 247.7 | 290.5 | 289.4 | 9.7 | 8.3 | 8.0 | 29.8 | 49.1 | 41.9 |
| Arrears | 8.4 | 15.4 | 19.0 | 24.7 | 25.3 | 25.1 | 0.1 | 0.5 | 0.3 | 0.2 | 0.4 | 0.4 |
| Debt service | 33.9 | 57.0 | 75.1 | 70.9 | 75.6 | 69.0 | 10.2 | 14.7 | 20.9 | 20.5 | 42.5 | 45.3 |
| International reserves | 96.9 | 225.5 | 571.7 | 1 315.7 | 1 856.7 | 2 292.4 | 18.2 | 35.3 | 103.2 | 198.5 | 302.3 | 274.8 |
| **Debt indicators (percentage)** | | | | | | | | | | | | |
| Debt service/exports | 15.5 | 12.9 | 9.9 | 5.1 | 4.0 | 2.7 | 25.1 | 20.6 | 14.6 | 7.5 | 12.9 | 11.4 |
| Total debt/exports | 123.9 | 105.3 | 64.8 | 38.5 | 34.7 | 29.7 | 288.3 | 190.1 | 122.7 | 85.3 | 87.0 | 78.2 |
| Debt service/GNP | 4.2 | 3.9 | 3.5 | 2.0 | 1.7 | 1.2 | 2.7 | 2.8 | 2.7 | 1.8 | 2.9 | 2.8 |
| Total debt/GNP | 36.9 | 35.4 | 25.2 | 18.4 | 17.0 | 13.8 | 36.5 | 29.2 | 23.7 | 21.7 | 21.1 | 19.4 |
| Reserves/short-term debt | 163.6 | 213.9 | 419.9 | 531.1 | 639.1 | 792.1 | 188.1 | 423.3 | 1 293.7 | 665.1 | 615.3 | 656.0 |
| Reserves/M2 | 14.9 | 16.2 | 19.8 | 28.0 | 32.4 | 31.0 | 10.7 | 14.1 | 22.2 | 24.7 | 28.8 | 22.9 |

| | *Europe and Central Asia* | | | | | |
|---|---|---|---|---|---|---|
| | *1990-94* | *1995-99* | *2000-05* | *2006* | *2007* | *2008*[b] |
| Total debt stocks | 230.3 | 355.6 | 555.5 | 911.4 | 1 262.6 | 1 367.0 |
| Long-term debt | 193.3 | 287.7 | 430.4 | 702.0 | 956.2 | 1 062.8 |
| Private (share) | 53.1 | 53.0 | 70.9 | 89.1 | 91.7 | 92.7 |
| Private non-guaranteed (share) | 4.3 | 15.8 | 41.0 | 66.8 | 72.0 | 71.8 |
| Short-term debt | 32.6 | 46.7 | 97.3 | 196.4 | 297.9 | 289.0 |
| Arrears | 22.8 | 27.4 | 15.1 | 4.5 | 4.7 | 5.0 |
| Debt service | 18.4 | 31.5 | 84.9 | 163.9 | 202.0 | 225.2 |
| International reserves | 23.1 | 72.9 | 195.8 | 542.1 | 785.1 | 728.5 |
| **Debt indicators (percentage)** | | | | | | |
| Debt service/exports | | 13.4 | 20.1 | 19.1 | 18.7 | 14.9 |
| Total debt/exports | | 130.1 | 121.4 | 96.8 | 107.9 | 90.7 |
| Debt service/GNP | | 3.4 | 6.7 | 6.9 | 6.6 | 6.0 |
| Total debt/GNP | | 38.5 | 45.7 | 38.4 | 41.5 | 36.3 |
| Reserves/short-term debt | 70.8 | 155.9 | 201.3 | 276.0 | 263.6 | 252.1 |
| Reserves/M2 | 13.6 | 31.6 | 46.4 | 57.3 | 58.9 | 44.5 |

*Source*: World Bank, *Global Development Finance 2009* (online database).

[a] Developing countries as defined in the Global Development Finance publication.

[b] Estimate.